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CBO LOW-BALLS BENEFITS OF THE GINGRICH TAX PLAN

The Congressional Budget Office (CBO) study of Speaker of the House Newt Gingrich's tax cut proposal is badly flawed. The tax cut would do more for the economy than the CBO projects.

Mr. Gingrich has introduced the Economic Growth Act of 1998, H.R. 4125. Representative Bill Archer, Chairman of the House Ways and Means Committee, asked the CBO to analyze the potential effect of the legislation on economic growth and revenue. The CBO report, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998", suggests disappointingly small benefits from the proposal.

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One of the provisions of the Act is a proposal to reduce the top tax rate on capital gains to 15 percent, for taxpayers in the 28% tax bracket and above, and to 7.5 percent for taxpayers in the 15% tax bracket. The CBO report focuses on that provision. Other provisions, such as full deduction of health insurance premiums by the self employed and marriage penalty relief, have less bearing on economic output, and are not reviewed (although the proposed cut in the Social Security benefits tax and earnings test would also boost saving and employment).

Static revenue loss from a rate cut.

A static estimate of the revenue loss from the proposed capital gains tax rate reduction would be about $16 billion a year, or $80 billion over five years. Using Joint Tax Committee and CBO methodology, about 70 percent of the static revenue loss will disappear, on a long term basis, due to additional trading of assets and reporting of gains. That would leave a net revenue loss of only $5 billion a year, or $40 billion over 5 years.

The revenue effect does not end with the "post-unlocking" revenue estimate, however. The cut in the capital gains tax lowers the cost of capital, and raises investment, productivity, wages, employment, and output. The rise in GDP would bring in additional revenues from other taxes (the "dynamic effect"). The CBO has brought together an advisory panel of researchers and modelers to examine in dynamic terms the issue of the effect of the capital gains tax (and other major tax changes) on GDP and income. There was, as always is the case among a group of economists, a divergence of opinion. Some participants predicted very little dynamic feedback. Moderate and larger responses were also predicted.

A middle of the road dynamic estimate of the consequences of the rate cut on the economy would show an increase in GDP of at least $10 billion. The higher GDP would bring in $3 billion in additional tax revenue, and cut the net revenue loss of the Gingrich proposal to a mere $2 billion a year. The gain in GDP ($10 billion) would be $5 for each dollar of net revenue loss ($2 billion). Put another way, not cutting the capital gains tax rate would cost the country $5 in lost income for each dollar of tax revenue the Treasury would save.

That means that everything bought by the government with the proceeds of this tax costs at

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
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least 5 times what it seems. If the government spends $1 on a ream of paper for a photocopier in the Transportation Department, that paper costs the American people $5 (a dollar in tax and $4 in additional lost after-tax income). That ream of paper had better be used for something awfully important to justify that cost.

A slightly higher economic growth assumption of $17 billion would recover the full $5 billion in static revenue loss after higher asset sales, and would show no net revenue loss from cutting the tax rate further from current levels. Under that assumption, the economic loss from not cutting the rate would be a total waste.

These assumptions, which CBO should have used in its analysis, would have revealed the capital gains tax to be an extraordinarily costly tax, and an extraordinarily bad one. The capital gains tax rate that puts its economic costs on a par with other taxes is zero. The capital gains tax is simply too destructive a tax to be considered competitive with other revenue sources. Thus, the tax neutral and economically optimal rate is zero. All fundamental tax reform proposals that aim for a neutral tax system recognize that fact, and eliminate separate taxation of capital gains.

CBO sides with the skeptics on capital gains.

In its report on Mr. Gingrich's proposal, however, the CBO sided with the extreme skeptics of the dynamic growth effects of the proposed capital gains reduction -- modelers who suggest that the GDP would rise by a mere $250 million to $2.5 billion. CBO cited a number of considerations that led them to believe that the effective tax rate on capital gains, and its effect on economic activity, is not as large as the statutory rate might indicate. In making these assumptions, the CBO made numerous conceptual errors and bad decisions that render their calculations invalid.

> ***[N]ot** cutting the capital gains tax rate would cost the country $5 in lost income for each dollar of tax revenue the Treasury would save. That means that everything bought by the government with the proceeds of this tax costs at least 5 times what it seems.*

CBO contends that the capital gains tax rate affects only a modest percent of saving decisions, and does not substantially affect the amount of saving or the cost of acquiring additional plant, equipment, buildings, or inventory. It adjusts the tax rate in its analysis to arrive at an "effective" capital gains rate that is much lower than the statutory rate, and employs that reduced rate in performing its dynamic economic analysis. Its adjustments are contrary to any reasonable theory of saving and capital investment.

The returns on capital include interest, dividends, and capital gains. Capital gains accrue mainly to equity-financed capital, rather than debt-financed capital. Some holders of equity are tax exempt; some delay selling assets, thereby postponing the tax; and some hold assets until they die, avoiding the tax altogether. CBO claims that these considerations reduce the "effective" capital gains tax rate and its effect on saving and capital formation.

Unfortunately, CBO is looking at the wrong tax rate. The CBO's "effective marginal tax rate" is a weighted average of marginal tax rates on the earnings of investments already being made by current savers and investors, and it is irrelevant to any cost of capital analysis. The relevant marginal tax rate is the rate that would be imposed on the earnings of additional investments that might be undertaken by marginal savers and investors, people who have the potential to expand their activity. That is a different kettle of fish.

Debt finance of investment does not diminish the adverse effect of the capital gains tax.

Much investment is financed by debt. CBO argues that lowering the capital gains rate does not lower the cost of debt-financed capital. CBO is mistaken. If the cost of equity finance is reduced by a cut in the capital gains tax rate, then the cost of any additional investment has gone down, because any new asset may be equity financed.

Regardless of how existing capital was financed, the question is how additional capital may be financed. Businesses have a choice of how to finance additional investment, either through debt or equity. According to capital theory, businesses use each available method of finance to the point at which they are of equal cost, at the margin. In such a circumstance, lowering the cost of either type of finance results in a lower cost of capital for new investment.

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There is a tax advantage to debt finance: it avoids the double taxation of corporate income that falls on dividends and capital gains. However, fixed debt service obligations impose inflexible costs on the business that can be difficult to meet in bad times, and excessive debt reduces a business's credit rating and results in higher interest costs. The more it borrows, the higher the cost it must pay, and the greater the financial risk it faces. Equity, however, is permanent financing whose returns can be varied as conditions demand.

Businesses borrow and issue equity until, at the margin, the costs of an added unit of debt and equity are equal. Therefore, lowering the cost of equity-financed investment lowers the cost of new investment by the full amount of the drop. New investment will be equity-financed instead of debt-financed. Some old debt-financed investment will be refinanced with equity, reducing businesses' exposure to fixed credit costs and their cost of debt finance as well.

Tax-exempt organizations do not mitigate the effect of the capital gains tax.

Some saving is done, and some investment is financed, by the assets of tax exempt organizations. Those savers pay no tax on capital gains in any event. But tax exempt organizations cannot be a major source of additional, marginal saving. Many of these organizations are constrained by law to use most of their donated revenues for their charitable purposes, and cannot substantially cut "consumption" and increase "saving", nor can they, like individuals, decide to work longer hours to earn additional income with which to save, because they are the passive recipients of donors' largesse.

Deferral of the capital gains tax does not diminish its impact on additional saving and investment.

Some taxpayers reduce the capital gains tax burden by deferring their gains; they simply hold onto the shares for longer than they otherwise might, and pay tax at a later time. The delay reduces the present value of the tax. However, the delay is not costless. People practice deferral only to the point at which the gains exceed the added costs. At the margin, any further deferral would cost as much as it would gain the saver, which means that, at the margin, the full capital gains tax rate applies. At the margin, deferral does not reduce the cost of the capital gains tax.

There are several reasons why deferral is not costless. Deferral requires delaying access to one's money. It prevents prompt reallocation or rebalancing of one's portfolio as one might wish,

and increases the portfolio's risk and reduces the risk-adjusted value to the saver. Delay might require not selling even if one thinks the market may go down, exposing the saver to higher market risk. Other risk abatement techniques, such as options, are rendered more expensive by the tax.

The ultimate deferral, step-up in basis at death, does not shelter marginal saving.

Some taxpayers escape tax on their capital gains through the "step-up" in basis at death. But assets held until death do not represent marginal saving. Most people hold some assets that they intend to sell or trade as well as others that they will hold longer term. If the tax on assets not held until death is reduced, then people will, 1) do more trading of assets they might otherwise have held until death (raising realizations and government revenue), and 2) add to their total stock of assets, in particular to the stock they intend to trade. The latter face the full marginal tax rate in the law.

CBO focuses on the marginal saver when it suits its case.

The CBO study does sometimes focus on the marginal saver and investor, but only when it appears to reduce the need for a capital gains tax cut. Some advocates of capital gains tax reduction make the incorrect argument that "unlocking" investments in old assets lets people reallocate tangible capital (actual plant and equipment, for example) from less productive to more productive uses. CBO correctly points out that the reluctance of some existing shareholders to trade stock would not, by itself, change the allocation of tangible assets among firms, if there were sufficient new (marginal) savers to fund the additional investments that firms wanted to make. CBO states on pages 8 and 9 of the study: "Investors who previously were locked in and who sell their stocks or bonds in response to a tax cut simply exchange those financial assets with other investors. The total amount of tangible capital in every firm and in the economy as a whole remains the same... The price of a widely traded stock in an efficient financial market will depend on what new investors are willing to pay for it -- that is, investors without a lock-in problem... The fact that *some* of the firm's potential investors may be locked in does not alter the firm's profit potential, and as long as there are enough investors who are not locked in, there should be no permanent effect on the firm's stock price."

Here, the CBO admits that the marginal savers and investors call the tune as to stock prices, the cost of capital, and the allocation of real assets. If this reasoning were applied consistently in the rest of the paper, all the arguments in favor of CBO's calculated reduction in the "effective" capital gains tax rate and in the estimate of the adverse impact of the tax on the economy would vanish, because people who really are the marginal savers and investors are fully subject to the capital gains tax on their incremental activity. (With respect to the specific quotation, CBO's focus on the marginal saver and the allocation of capital is correct, but the rest needs clarification and correction. Although a new saver may not yet be locked in, he may well become so if he holds the asset long enough, and his return on saving is surely diminished by the tax even if (especially if) he trades the securities. Consequently, although, as CBO states, the mere trading of old shares does not affect the total or the allocation of existing tangible capital, the capital gains tax does reduce the total amount of tangible capital in the economy.)

It is nice to see, at long last, some effort to factor in the dynamic responses of the economy to changes in taxation. However, the Congress needs analysis of higher quality if anything useful is to come of the exercise, and if the public is ever to realize the enormous economic benefits of an improved tax system.

Conclusion.

Conceptual errors in the CBO analysis of Speaker Gingrich's tax cut proposal render its results invalid. The tax cut would do more for the economy than the CBO projects.

The errors in the CBO analysis involve a basic misunderstanding of capital theory and microeconomics. They cannot be argued away as a matter of disagreement over empirical evidence from the historical data, nor the difficulty of sorting out the effect on one variable on the economy from among a slew of other simultaneous influences. They are simply wrong.

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Stephen J. Entin
Executive Director and Chief Economist

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